BUSINESS VALUATION REVIEW

USING PRICE-ADJUSTMENT CLAUSES IN NON-ARM'S LENGTH TRANSACTIONS

by

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Under section 482 of the *Internal Revenue Code*, the Internal Revenue Service may allocate income, deductions, and credit among non-arm's length taxpayers to prevent tax evasion or to reflect the true income of a taxpayer. Under Regulation §1.482-1(b)(1), in determining the true taxable income of a controlled taxpayer for U.S. tax purposes, the standard to be applied is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.[1] In reporting "true taxable income", rather than the actual income resulting from a non-arm's length transaction, the final Regulations provide that true taxable income is a condition that exists when a controlled taxpayer reports financial results that are consistent with the results an uncontrolled taxpayer would have achieved under comparable circumstances.

It is not the intention of this article to delve into the transfer-pricing issues or the prescribed methods for analyzing transfer prices. These are the subject of extensive analytical commentary appearing in a variety of publications and conference proceedings.[2]

Canada's tax laws (section 69 of the Canadian *Income Tax Act*) contain similar provisions to those of IRC section 482. However, in contrast to §482 Regulations, which would require the making of a "correlative adjustment" (i.e., a corresponding adjustment to the accounts of the entity on the other side of the transaction), the Canadian rules can expose a taxpayer to significant penalties in the form of double taxation (as well as interest) if, subject to some specific exceptions, a non-arm's length transaction is not carried out at fair market value. In Canada, taxpayers are considered not to deal with each other at arm's length if they are related or if, in fact, they do not deal at arm's length (e.g., substantial dependency by one party on the other).

The Canadian tax laws also contain special elective ("rollover") provisions that can be applied under specified circumstances; these are exceptions to the general rules outlined above. The rollovers most often relate to income tax and estate planning situations, or corporate reorganizations, in which there is no intention for there to be an actual realization of the value of an economic interest, as would be the case in an arm's length sale. A rollover has the effect of permitting immediate tax to be avoided, thereby permitting a tax deferral. However, even when the related parties elect to have the "rollover" provisions apply, there still remains potential exposure to material adverse tax consequences if fair market value is different from the value reported by taxpayers.

The *Income Tax Act* provides that, except as specifically provided otherwise, where tangible or intangible property is sold by a taxpayer to a person with whom he or she does not deal at arm's length for less than fair market value (or disposed of for no proceeds at all), the taxpayer is nonetheless deemed to have received fair market value. A Canadian taxpayer is thus prevented from reporting artificially reduced sales proceeds in reporting taxable income.

Similarly, where a taxpayer *acquires* property from a non-arm's length party for a price that exceeds fair market value, the taxpayer is deemed to have acquired the property at the fair market value thereof.[3] This provision has the effect of counteracting any attempt by a taxpayer to inflate the tax cost basis of an asset in a non-arm's length transaction.

The following are some examples:

Assume that a taxpayer owns shares of a closely-held company, which have a cost basis of $80,000 and a fair market value of $150,000. If the shares are sold at their fair market value, the taxpayer would realize a capital gain of $70,000 ($150,000 minus $80,000) and the purchaser of the shares would have a cost basis of $150,000, being the price paid. This would be the tax result whether or not the buyer and seller were related.

Assume, however, that a non-arm's length transfer of these shares were to take place at $125,000. Under the Canadian tax laws, the seller would be deemed to have received the full fair market value of the shares, namely $150,000, even though the actual sales proceeds were only $125,000. As there is no special (corresponding) adjustment applicable to the *purchaser* in such a case, his or her cost basis of the shares would remain at the transaction price of $125,000. This would result in double-taxation on the difference between (a) the $125,000 actual transaction price and (b) the fair market value of the shares, $150,000. That is, the seller would be *deemed* to have received $150,000 even though he or she would have *actually* received $125,000. However, because the non-arm's length purchaser would have paid only $125,000 for the shares, that would be the cost basis of the shares for Canadian tax purposes because, unlike the section 482 provisions in the U.S., there would be no corresponding adjustment (to the related purchaser's cost basis) for the $25,000 increased proceeds ($150,000 minus $125,000) to the seller. The related group will be taxed twice on the same $25,000 — once when the original non-arm's length sales occurs and the seller's proceeds are notionally increased to $150,000, and again when the *purchaser* sells the shares at some point in the future, because the latter's cost remains at $125,000.

Assume, however, that these same shares are, instead, transferred at $220,000 when the fair market value is $150,000. This will result in a capital gain to the seller of $140,000 ($220,000 minus the cost of $80,000). Because, under the tax laws, the purchaser will be deemed to have paid a price equal to the fair market value of the shares ($150,000), this would be his or her cost basis for tax purposes. Therefore, when the purchaser sells the shares in the future, a capital gain will be recognized to the extent that the sales proceeds exceed $150,000 (even though this related-party purchaser had actually paid $220,000). As the non-arm's length *seller* would have already been taxed on the portion of the selling price between the $150,000 and the $220,000, being the actual proceeds (and there is no downward adjustment provided for in the tax laws), the group would face double taxation on $70,000 ($220,000 minus $150,000).

In summary, a non-arm's length sale of any asset at a price that is either above or below fair market value will result in double-taxation on that portion of the gain that would be recognized at a subsequent future date, i.e., when there is an actual arm's length sale of the property by the transferee. (As noted above, there are specific rollover provisions which override the inadequate-consideration results just reviewed. These have the effect of deferring immediate taxation.)

If, however, there has been *bona fide* attempt to determine the fair market value of the property and to transfer it at that price, the one-sided adjustment resulting from the operation of section 69 will not generally be applied by the Canada Customs and Revenue Agency ("CCRA" — formerly Revenue Canada). The good-faith factors are similar to those applied under the U.S. valuation penalty rules in section 6662 of the *Internal Revenue Code.*

For obvious reasons, Canadian business valuators are frequently asked to opine on fair market value when non-arm's length transactions are being contemplated. The valuation is commissioned for purposes of determining a proposed transfer price (say, of shares of a family-owned operating company to a holding company in a tax or estate plan, or the transfer of an asset from a corporation to a shareholder); and to comply with the stated policies of the CCRA when a non-arm's length transfer is contemplated by family members or parties within a related corporate group.

USE OF A PRICE-ADJUSTMENT CLAUSE

Because of the potential significant exposure and financial risk to taxpayers and business valuators that can arise when a sale takes place between non-arm's length parties and the Canadian tax authorities subsequently determine that the fair market value of the asset is higher or lower than the actual transaction price, a price-adjustment clause is usually incorporated in the purchase and sale agreement.

The price-adjustment clause is used in order to avoid adverse tax consequences (one-sided adjustments, taxable shareholder benefits, etc.), such as those noted above, should the CCRA dispute the declared fair market value of the asset(s) transferred. It would provide for an adjustment to the transaction price in the event that a third party, such as CCRA or a court, determines that the transaction price (i.e., "fair market value" ultimately determined) of the property is other than the fair market value declared by the transacting parties.

As noted above, while the fair market value of the transferred asset will be deemed to have been received by the transferor for tax purposes, there is no provision in the Act for a corresponding upward adjustment to the price paid by the purchaser. Thus, when there is a non-arm's length transaction, including rollovers in conjunction with corporate reorganizations and estate freezes, the adverse tax consequences summarized above may apply if the CCRA disagrees with the value of the consideration transacted between the parties — hence the inclusion of a price-adjustment clause in the purchase and sale agreement.

The *Guilder News* Decision

Prior to a precedent-setting decision of the Canadian Federal Court of Appeal,[4] taxpayers would include a price-adjustment clause in the sale agreement so that, in the event the CCRA might subsequently determine the fair market value of the transferred assets to be less or greater than the price stipulated in the agreement, the price would automatically be adjusted, retroactive to the transaction date, to the fair market value determined by the CCRA, with no adverse tax consequences. In other words, the way it used to be was more or less as follows: "We'll transact at $X and if the CCRA successfully challenges us (or if we get caught!), we'll simply adjust the price retroactively, with no adverse tax effects!"

However, in the *Guilder News* case, the CCRA assessed based on the assumption that the sale of property by the taxpayer's corporation to the shareholder at a price less than fair market value was a device adopted for the purpose of conferring a shareholder benefit that would have otherwise been taxable under the relevant provisions of the Canadian tax laws. The shareholder was assessed on a taxable benefit equal to the excess of (a) the fair market value of the assets acquired from his company over (b) the price the shareholder paid to the company.

The purchase and sale agreement contained a price-adjustment clause that read as follows:

> "4. It being the intention of the Vendor and the Purchaser that the prices herein stipulated should represent the fair market value of the shares being purchased and sold herein, the parties hereto agree that in the event that the Minister of National Revenue should at any time hereafter make a final determination that the fair market value of the said shares as of the date of the Agreement is less than or greater than the prices herein stipulated, the prices herein stipulated shall be automatically adjusted *nunc pro tunc* [retroactively] to conform with such fair market value as finally determined and all necessary adjustments shall be made, including adjustment of the above-mentioned promissory note."

The CCRA assessed taxes under the shareholder-benefit provisions. Refusing to recognize the price-adjustment clause, because the parties had not reasonably, and in good faith, attempted to transact at fair market value, Chief Justice Jackett of the Federal Court of Canada stated[5]:

> "If, in fact, a company simply sold property to its sole shareholder on expressed terms that the price payable was an amount equal to fair market value and provided a fair manner to determine such value, I would agree with the contention on behalf of the appellants that there could not, as a matter of law, be a benefit arising out of the sale.
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> "In my view, however, the ... sale was not such a sale.
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> "In the first place, it is common ground that 'the purchase price in each transaction was *obviously* less than the fair market value of the shares being sold … ' (the italics are mine) as appears from the Memorandum of Fact and Law filed in this Court on behalf of the appellants at paragraph 7. It follows that, at least with regard to the sale price set out in the contract, the statement in the opening words of clause 4 that it was 'the intention of the Vendor and Purchaser that the prices herein stipulated should represent the fair market value … ' is a departure from the truth and can have no effect (unless it be as evidence that the clause was in fact a 'sham')."
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> …
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> "This agreement is radically different from a sale that is expressly made for a consideration equal to value. This is an agreement for a sale *at a price obviously less than value, which price is to be the only amount payable until such time, if any, as the Minister of National Revenue determines the value of the shares that happen to be the subject matter of this sale*. While it can be said, as a matter of law, that a simple sale for value, with no other provisions, cannot result in a benefit, it cannot be said, as a matter of law that the ... sale is such a sale merely because it is an agreement containing clause 4. That sale is at a substantial undervaluation and, except in a certain event, it will continue indefinitely to be so. Even if that event should arise at some subsequent time, the individual will have had the benefit of not having had to pay the amount in excess of the 'price' until that subsequent time and this, in days of high interest, can be substantial benefit." (Emphasis added.)[6]

The effect of the *Guilder News* decision is that taxpayers in Canada cannot now take the chance that, if the CCRA should ultimately challenge the transaction price, such artificially increased or reduced price be automatically adjusted so that there would be no adverse tax consequences, as summarized above.

Effectiveness of the Price-Adjustment Clause

The CCRA periodically issues *Interpretation Bulletins*, similar to the IRS's publication of *Revenue Rulings*. Armed with the *Guilder News* judgment of the Federal Court of Appeal, the CCRA issued *Interpretation Bulletin* IT-169, entitled "Price Adjustment Clauses",[7] outlining its policy in this regard. The CCRA states that it *will recognize the intended effect of a price-adjustment clause,* but only provided that each of the following conditions is met:

1. The agreement provides a *bona fide* intention of the parties to transfer the property at fair market value and the value was arrived at by a fair and reasonable method;
2. Each of the parties to the agreement notifies the CCRA in his tax or her return for the year indicating that he is prepared to have the price reviewed by the CCRA, that he or she will take the necessary steps to settle any resulting excess or shortfall and that a copy of the agreement will be filed with the CCRA if and when demanded; and
3. The excess or shortfall is actually refunded or paid, or the legal liability therefor is adjusted.

(Few practitioners recommend that their clients comply with the second point, and the CCRA seems to accept this.)

Therefore, for a price-adjustment clause to be effective, a *bona fide* attempt must be shown to have been made to transact at a fair market value, arrived at by adopting a fair and reasonable valuation approach and employing appropriate valuation techniques. Presumably, this would require adherence to generally-accepted business valuation principles, practices and standards[8], in the determination of fair market value. Also, regard should be had to the CCRA's own position as set out in *Information Circular 89-3*, "Policy Statement on Business Equity Valuations".[9]

However, as diligent, objective and thorough the valuation process might be, there nonetheless will continue to be the "classic" issues that may be contested by the CCRA when a non-arm's length transfer occurs. These are substantially similar to the issues addressed by the IRS valuators and that contiue to be tried by the tax courts on both sides of the border.

Canadian business valuators are understandably extra cautious. As described in my article in the March 2002 issue of *Business Valuation Review,* Canada has recently enacted new tax legislation, which gives the CCRA far-reaching powers. Canada's penalty provisions will apply to any person who advises or participates in the making of a "false statement" or omission relative to tax matters, which could be used by another person (including a partnership) in connection with Canadian tax law. "Valuation activities" are subject to these civil-penalty offences.[10] Similar to the rules in the U.S., if the reported fair market value was arrived at in good faith and there was reasonable cause for the over- or understatement of value (i.e., the false statement), there are exculpatory provisions.

It should be noted that a "false statement" for purposes of the valuation penalties is a statement that is *misleading* as opposed to *inaccurate*.

If the fair market value of an asset, or of a service, falls outside a prescribed range[11], the valuator is deemed to have made a false statement that he or she could reasonably be expected to have known, but for circumstances amounting to "culpable conduct" (see below), was a false statement. This deeming provision would not apply to a valuator who can establish that the fair market value opined on was reasonable in the circumstances, the statement was made in good faith, and, where applicable, the statement was not based on one or more assumptions such that the valuator knew, or would reasonably be expected to know, but for circumstances amounting to culpable conduct, that the assumptions were unreasonable or misleading in the circumstances. However, if the valuation was based on false or misleading information and/or assumptions such that this conduct is determined to be "culpable conduct", the valuator would be penalized — and the penalty could be severe.

Example of Price-Adjustment Clause

An example of the type of price-adjustment clause currently included in a purchase and sale agreement between non-arm's length parties (e.g., the transfer of family-corporation shares among a related group, or of operating-company shares from a shareholder to his or her holding company, etc.), in very simplistic terms, is as follows:

> "The parties hereto, when establishing the Purchase Price, have, in good faith, used their best efforts in determining the fair market value of the Shares as of the transaction date ("Effective Date"). As the intention of the parties is for the Purchase

> Price to be equal to the fair market value of the Shares as of the Effective Date, the parties agree that:
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> (a) if it is subsequently determined that the fair market value of the Shares is misstated; or
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> (b) should the Revenue Authorities determine that the fair market value of the Shares (the "Substituted Value") is greater or less than that fixed by the Vendor and the Purchaser pursuant to this agreement,
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> then the Vendor and the Purchaser may adjust the Purchase Price, retroactive to the Effective Date, to equal the Substituted Value.
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> If, however, as a result of a negotiation, an objection and/or appeal, it is finally determined, whether by agreement with the Revenue Authorities or as a result of a hearing before the Tax Court or otherwise, that the fair market value of the Shares is greater or less than the Purchase Price, then the Purchase Price and the consideration received by the Vendor shall be automatically adjusted, retroactive to the Effective Date, so that the Purchase Price of the Shares and the consideration received are equal to the fair market value as finally determined."

An effective price-adjustment clause should therefore permit the related parties to adjust the transaction price with the result that the non-arm's length proceeds to the seller and the cost basis to the buyer are at the fair market value finally agreed upon with the Revenue Authorities, or as adjudicated by the court, without the adverse tax consequences outlined earlier.

Endnotes

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(1) The 1994 final transfer pricing regulations provide that, "if necessary to reflect an arm's-length result, a controlled taxpayer may report ... the results of controlled transactions based upon prices different from those actually charged". Regulation §1.482-1(a)(3).

(2) See, for example, S.P. Pratt, R.F. Reilly, and R.P. Schweihs, *Valuing a Business — The Analysis and Appraisal of Closely Held Companies*, Fourth Edition, McGraw Hill (New York: 2000), pp. 658 ff.; J.A. Bogdanski, *Federal Tax Valuation*, Warren, Gorham & Lamont, loose-leaf service, pp. 2-141 ff.; W.E. Bonano, "Transfers of Intangible Property Under Section 482", *International Tax Bulletin*, February 1999, Pillsbury Madison & Sutro LLP, San Francisco.

(3) Paragraph 69(1)(a) of the *Income Tax Act.*.

(4) *Guilder News Co. (1963) Ltd. et al* v. *MNR* , 73 DTC 5048 (FCA), aff'g 72 DTC 6146 (FCTD).

(5) 73 DTC 5048 (FCA), at pp. 5051 and 5052.

(6) At pp. 5051 and 5052.

(7) August 6, 1974.

(8) See, for example, Richard M. Wise, Jay E. Fishman and Shannon P. Pratt, *Guide to Canadian Business Valuations* (Volume 1), Carswell (loose-leaf service).

(9) August 25, 1989.

(10) Subsection 163.2(2).

(11) Prescribed by the Regulations under the Act.